



MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

To: Robynn Wilson, Chair
Members of MTC Income & Franchise Tax Uniformity Subcommittee
From: Shirley Sicilian, General Counsel
Date: February 18, 2011
Subject: **Model Compact Art. IV.17 Amendments**

The Subcommittee is continuing to work through the drafting group's¹ list of three remaining policy questions for Compact Art.IV.17 (see Attachment A) and to review the draft model that reflects the Subcommittee's policy answers (see Attachments B Markup and C Clean).

During its teleconference on October 19, 2010, the Subcommittee answered the first two of the three policy questions, and asked the drafting group to:

1. Include explicit regulatory authority, and
2. Include an explicit requirement that taxpayer reasonably approximate the market if sourcing cannot otherwise be specifically determined under the rule.

During its December 7, 2010 in-person meeting, the Subcommittee began to address the third remaining policy question: how to source receipts from sales and licensing of intangibles. This question is divided into two parts. The first part, 3.A., covers receipts from intangibles that were held as taxpayer's product for sale or license to its customers.² The second part, 3.B., covers receipts from sale or license of intangibles that are or were used by the taxpayer as an asset in its unitary business.³ In December, the Subcommittee focused on the first part, 3.A, and directed drafting group to:

1. Separately source receipts from transactions involving intangible products depending on whether the transaction was a license or a sale.
2. For receipts from the *license* of intangible products, source to the location where the intangible is "used." If the intangible is used in whole or part for "marketing," the location of use should be the location of the consumer. (That is, follow the Massachusetts approach).
3. For receipts from the *sale* of intangible products, identify reasonable sourcing options for further Subcommittee consideration.

¹ Drafting group includes Ben Miller, Melissa Potter (CA-FTB); Joe Garrett (AL); Michael Fatale (MA); Debra Buchanan, Gary Humphrey (OR); Ted Spangler; and Staff, Bruce Fort and Shirley Sicilian.

² These would include receipts from intangible transactions occurring in the ordinary course of the taxpayer's regular trade or business – e.g., license of trademarks, or sale or license of patents or copyrights.

³ These would include receipts from non-inventory assets that are or were used in the operation of taxpayer's unitary business – such as good will, working capital, treasury function related investment assets, or sale of patents/copyrights that had previously been used by the taxpayer to manufacture its own product for sale to its customers.

During its February 8, 2011 teleconference, the Subcommittee began its review of the attached draft, reflecting Subcommittee direction on questions 1 through 3.A. Note that under §17(a)(5) the drafting group is suggesting that sales of only certain types of intangibles – those for which the market is likely to be known by the taxpayer – should be specifically sourced. These are sales of a contract right, government license⁴, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area. Other sales are explicitly removed from sourcing, because even though a taxpayer may be able to apply the sourcing rule at the time of the sale, it may be impossible for the tax department to verify later that it had been applied appropriately. This approach would follow that currently being proposed in Massachusetts.

The Subcommittee indicated it would continue to discuss the attached draft at the March 2, 2011 meeting in Kansas City, Missouri. It also indicated that, in order to conclude question 3.B., it would specifically address revisions to Article IV.1(g), the definition of “sales” at the March 2, 2011 meeting. That discussion will take place under the agenda topic “Project to Amend Multistate Tax Compact Article IV.1(g) (Definition of Sales).”

⁴ “Government license” does not refer to patents or copyrights, but rather to franchises or rights of way granted by the government.



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**Model Compact Art. IV.17 Amendments
Income & Franchise Tax Uniformity Subcommittee**

**Remaining Policy Questions
For Discussion Purposes Only**
► Showing Subcommittee Answers

January 31, 2011

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- 1. Explicit Regulatory Authority.** Should an explicit reference to regulatory authority be added to Section 17? For example:

17(c) The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.”

► Subcommittee: yes, include reference in statute.

- 2. “Reasonable Approximation”.** With the removal of the “cascade” language, is it necessary that the statute explicitly authorize “reasonable approximation” directly in the sourcing provision (a)?

- A.** Would “reasonable approximations” be better as part of the “contingency” provisions under 17(b)? For example:

17(a) Sales, other than sales described in Section 16, are in this State if the taxpayer’s market for the sale is in this state. The taxpayer’s market for a sale is in this state...

(3) In the case of sale of a service, if and to the extent the service is delivered to a location in this state; ~~provided, that if such location cannot be determined, it shall be reasonably approximated;~~

(4) In the case of sale, lease or license of intangible property, if and to the extent the intangible property is used by the payor in this state; ~~provided, that if the location of such use cannot be determined, it shall be reasonably approximated.~~

(b) If the taxpayer is not taxable in a state to which a sale is assigned, or if the state of assignment under subsection (a) can not be determined ~~under subsection (a) or reasonably approximated~~, such sale shall be excluded from the denominator of the sales factor.

- B. Or, could “reasonable approximations” be allowed, and better addressed, through regulation?

► *Subcommittee: Should include reasonable approximation in statute.*

3. **Sale or License of Intangible Property.** When the taxpayer sells or licenses intangible products, how should it source the receipts from that sale or license? In **section 3.A**, we consider sourcing for receipts from intangibles that are sold or licensed by the taxpayer as a product which the taxpayer provides to its customers. In **section 3.B**, we consider receipts from non-inventory, business assets – such as good will, working capital, or treasury function related investment assets – that are or were used in Taxpayer’s own unitary business.

A. Receipts from intangible property that was held as inventory for sale or license to taxpayer’s customers. These would include receipts from intangibles transactions occurring in the course of the taxpayer’s regular trade or business, including receipts from intangibles that had been held as inventory for sale or license to customers – such as, logo’s, cartoon characters, or patents/copyrights that are held for sale/license in the ordinary course of business to taxpayer’s customers.

- i. **Sourcing options.** Where is the “market” for the sale or licensing of intangible property?

- a. Where delivered? (Same rule as used for tangible property in current model and for services in draft model.)
- b. Taxpayer’s commercial domicile?
- c. Customer’s commercial domicile?
- d. Customer’s billing address?
- e. Customer’s office from which product was ordered?
- f. As provided by contract?
- g. Customer’s activities?
 - (1) Customer’s use of the intangible in state? (E.g., customer’s production of a patented product in the state. Or customer’s use at the time of purchase? And, if used in more than one state, a ratio of the customer’s location of use at the time of purchase in this state compared to the customer’s location of use at the time of purchase everywhere?)
 - (2) Customer’s sales to customer’s customers in state? (Or customer’s sale of a product to customer’s customers that results in fees for the taxpayer.)
- h. Population (relative to other states in the area where the taxpayer’s customer is permitted to use the intangible)?

- ii. **Use multiple sourcing options?**

- a. **Differentiate between different types of transactions?** *See, e.g., CA draft in appendix*

- (1) **Complete transfer** (Sale)
 - (2) **Anything less than a complete transfer** (Licensing, leasing, rental or other permission to use of intangible property, including franchises, patents, copyrights, licenses, plans, specifications, blueprints, processes, techniques, formulas, designs, layouts, patterns, drawings, manuals, technical know-how, and contracts pursuant to a licensing, leasing, rental, or similar agreement, etc.)
- b. **Differentiate between different types of intangibles?** *See, e.g., MA rule (partially superseded) in appendix.*
- (1) **Commercial and Trade intangibles** (e.g., commercial intangibles may include patents, know-how, designs and models used in production of goods or provision of services, and computer software; and trade intangibles may include research and development activities. OECD)
 - (2) **Marketing intangibles** (e.g., marketing intangibles include trademarks and trade names used to commercially exploit a product or service, customer lists, distribution channels, and unique names, symbols, or pictures with important promotional value. OECD)
 - (3) **“Mixed” intangibles.**
- c. **Differentiate between different types of customers?**
- (1) **Individual persons, main street business vs. multistate businesses?**
Customers that are individual persons or “main street businesses” are likely to be more easily located in a single state because all relevant activities are more likely to be in that single state. But when the customer is a multistate business with activities in more than one state, then do we need to more specifically identify which activity(s) will determine the state to which we’ll source?
 - (2) **Related entity customers vs. unrelated entity customers?** If the general rule is conceptually good for most situations, but might allow for manipulation, should we consider a special rule for situations where taxpayer and customer are related entities?
- d. **“Cascades?”** Should alternative rules be provided in the statute for those situations where information needed to source based on the primary rule(s) is not “readily determinable?” Or should “reasonable approximations” of the primary rule be allowed in statute and/or identified in regulations? *See, e.g., CA draft rule, MA rule (partially superseded), both in appendix.*

► Subcommittee: Differentiate between license and sale of intangible. Further differentiate between license of “marketing” intangible and licence of other types of intangibles, treating “mixed” intangibles as “marketing” intangibles. Source licensing of intangibles to place of “use” where “use” of marketing intangibles is location of consumer.

B. Receipts from sale or license of intangible property that is or was used as a business asset in TP’s unitary business. These would include receipts from

non-inventory, business assets that are or were used in Taxpayer's unitary business – such as good will, working capital, treasury function related investment assets, or patents/copyrights that had previously been used by the taxpayer to manufacture its own product for sale to its customers.

- i. Included in gross receipts?** *See* policy checklist for definition of “sales.” Should the sales factor include gross receipts from transactions involving taxpayer's intangible property that is not inventory, but is (or was) instead used in the unitary business? Should the answer to this question be the same as for gross receipts from transactions involving taxpayer's other (real and TPP), business assets?
- ii. Sourcing options** (if included in gross receipts):
 - a.** The same as receipts from intangible products sold or leased (marketed) to “customers” are sourced?
 - b.** The same as receipts from sale of real or tangible assets used in the business would be sourced?
 - c.** Buyer's commercial domicile?
 - d.** Taxpayer's commercial domicile? *See, e.g.,* UDITPA or MA rule (partially superseded), both in appendix.



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Model Compact Art. IV.17 Amendments
Draft – for Discussion Purposes Only
Sources Gross Receipts - Narrowly Defined

1-31-2011

17(a) Sales, other than sales described in Section 16, are in this State if the taxpayer's market for the sale is in this state. The taxpayer's market for a sale is in this state:

- (1) In the case of sale, rental, lease or license of real property, if and to the extent the property is located in this state;
- (2) In the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;
- (3) In the case of sale of a service, if and to the extent the service is delivered to a location in this state; ~~provided, that if such location cannot be determined, it shall be reasonably approximated;~~
- (4) In the case of ~~sale~~, lease or license of intangible property; or sale or other exchange of such property if the receipts from such sale or exchange derive from payments that are contingent on the productivity, use, or disposition of the property; if and to the extent the intangible property is used ~~by the payor~~ in this state, provided that ~~if the location of such use cannot be determined, it shall be reasonably approximated~~ intangible property used in marketing a good or service to a consumer is used in this state if the good or service that is marketed using the intangible property is purchased by a consumer who is in this state; and
- (5) In the case of sale of intangible property other than that referenced in section (4), above; where the property sold is a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area; if and to the extent the intangible property is used in or otherwise associated with this state, provided that any sale of intangible property not otherwise described in this section (5) or section (4) above shall be excluded from the numerator and the denominator of the sales factor.

- (b) If the state of assignment cannot be determined under subsection (a), it shall be reasonably approximated.
- (c) If the taxpayer is not taxable in a state to which a sale is assigned under subsection (a), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (~~a~~b), such sale shall be excluded from the denominator of the sales factor.
- (~~e~~d) The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.



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Model Compact Art. IV.17 Amendments – Draft – for Discussion Purposes Only
Sources Gross Receipts - Narrowly Defined
1-31-2011

- 17(a) Sales, other than sales described in Section 16, are in this State if the taxpayer's market for the sale is in this state. The taxpayer's market for a sale is in this state:
- (1) In the case of sale, rental, lease or license of real property, if and to the extent the property is located in this state;
 - (2) In the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;
 - (3) In the case of sale of a service, if and to the extent the service is delivered to a location in this state;
 - (4) In the case of, lease or license of intangible property; or sale or other exchange of such property if the receipts from such sale or exchange derive from payments that are contingent on the productivity, use, or disposition of the property; if and to the extent the intangible property is used in this state, provided that intangible property used in marketing a good or service to a consumer is used in this state if the good or service that is marketed using the intangible property is purchased by a consumer who is in this state; and
 - (5) In the case of sale of intangible property other than that referenced in section (4), above; where the property sold is a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area; if and to the extent the intangible property is used in or otherwise associated with this state, provided that any sale of intangible property not otherwise described in this section (5) or section (4) above shall be excluded from the numerator and the denominator of the sales factor.
- (b) If the state of assignment cannot be determined under subsection (a), it shall be reasonably approximated.
- (c) If the taxpayer is not taxable in a state to which a sale is assigned under subsection (a), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such sale shall be excluded from the denominator of the sales factor.
- (d) The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.